New South Wales
TREASURY

SUBMISSION TO THE REVIEW OF THE COMMONWEALTH GOVERNMENT SECURITIES MARKET

Scope

This submission is limited to comments on only some of the issues raised in the discussion paper, namely:

- the role of Commonwealth Government Securities as long term investments;
- implications for the cost of capital;
- promoting Australia as a global financial centre; and
- options available to the Commonwealth.

The comments proffered on these issues reflect the NSW experience with similar issues at the State level. NSW Treasury recognises there may be additional policy considerations to which the Commonwealth should have regard.

Executive summary

1. In addition to debt, the NSW general government sector has incurred liabilities as a legacy of its employment arrangements (defined benefit superannuation) and as a consequence of its policy decision to self insure. The NSW government holds financial assets for the purpose of funding, over a controllable period of time, the liabilities it has incurred.
2. As a large investor in financial assets, including Commonwealth government bonds, the NSW Government would prefer a liquid Commonwealth government securities market continued to operate, without further reduction in size.
3. As an investor, the NSW government demand for Commonwealth government bonds as long term investments is likely to rise as full funding of superannuation liabilities is approached and as superannuation pension liabilities come to predominate.
4. The preferred option is for the Commonwealth to gradually begin to fund its accrued superannuation liabilities, overseen by a trustee.
5. If the Commonwealth decides to further reduce the value of bonds outstanding, the reduction should be gradual. Financial markets should be informed of the intended rate of change in the value of Commonwealth government bonds outstanding, to provide time for the development and deepening of markets for alternative interest rate risk instruments.

December 2002

Cost of capital

If the Commonwealth decided to wind down the Commonwealth government bond market, it is likely that the average cost of capital to borrowers would increase.

Such an increase in the cost of capital is likely because alternative instruments for managing interest rate risk, such as swaps, have higher transaction costs, have some credit risk and are less transparently priced than Commonwealth government bonds in secondary bond markets.

The submission by NSW Treasury Corporation (TCorp) provides more detail on the reasons why the average cost of capital to borrowers would increase.

For the NSW government to retain the capacity to borrow in capital markets, a liquid and efficient secondary market in State government bonds continues to be necessary.

NSW does not have an explicit target for the size of the State government bond market. Having a reasonably constant level of NSW TCorp bonds on issue has not noticeably impaired liquidity.

The secondary market in Commonwealth government bonds does not need to grow at any predetermined nominal rate in order to maintain liquidity. The expansion of interest rate derivatives (particularly futures) has met some of the growing demand for exposure to government bonds.

If the Commonwealth decided to wind down the Commonwealth bond market, it is likely there would be an increase in demand for NSW TCorp bonds, reducing the cost of capital for the NSW government as a borrower. Despite this potential benefit, winding down the Commonwealth bond market is not the preferred option, because, across the economy, the average cost of capital is likely to rise, and as an investor, the NSW government values Commonwealth government bonds as the "risk free" asset and as long term investments.

Eliminating net debt (funding debt liabilities)

The NSW government has a fiscal policy objective of minimising the level of net financial liabilities (NFL), by eliminating general government sector net debt by 2020, fully funding State sector accrued superannuation liabilities by 2030 and fully funding general government sector incurred insurance liabilities.

Eliminating net debt has not been pursued ahead of the overall financial liability management objectives. A balanced approach has been taken between reducing net debt and minimising other liabilities: at times, available funds that could have been used to retire debt have been contributed towards funding superannuation or insurance liabilities. Thus, while net debt has been substantially reduced, it could have been reduced further had the government not pursued broader liability management goals.

From the perspective of managing a government balance sheet, the level of net financial liabilities is an appropriate fiscal policy objective, because it is a more complete measure of a government's accrued financial obligations than is net debt.

Net financial liabilities measure the difference between liabilities (mostly consisting of accrued superannuation benefits, debt, insurance and long service leave) and financial assets (cash and deposits, advances and loans, and investments).

Contrary to a statement in the discussion paper (p103), in calculating net debt and net financial liabilities, there is no difference between investing in bonds and investing in equities.

The NSW government has a target of eliminating general government sector net debt over 25 years to 2020. Public trading enterprises, on the other hand, are generally geared at comparable levels to private sector businesses in the same industry.

While substantial progress has been made in reducing general government sector net debt, the level of State Government (TCorp) bonds on issue has remained reasonably constant at about $20 billion.

Funding insurance liabilities

The NSW government self insures its general government sector, with public trading enterprises free to make their own commercial decisions about insurance arrangements. It is common for large entities to self insure, while smaller entities typically pool their insurable risks.

The NSW government has recently adopted a policy of fully funding incurred insurance liabilities. This implies that the Treasury Managed Insurance Fund's financial assets of $4 billion will grow to between $10 billion and $15 billion by 2030.

NSW Treasury acknowledges that there are financial risks involved in holding such financial assets, particularly the volatility of investment returns and the occurrence of negative investment returns from time to time.

The financial risks involved in insuring with the commercial insurance market would be substantial. Recent experience demonstrates that the cost of insurance cover can be volatile.

More seriously, recent experience also demonstrates that the availability of insurance (and reinsurance) cover cannot be taken for granted.

The financial risks in self-insuring without holding financial asset reserves would also be substantial. The level of insurance claims payable from year to year is volatile. Catastrophes are unpredictable and solvency is at a premium for a self-insurer when they occur.

The Treasury Managed Insurance Fund invests in both bonds and equities. The Fund's bond holdings are diversified between different issuers, with specified limits on the proportion of the bond portfolio issued by a single party. The exception to these limits concerns Commonwealth government bonds – the Fund may choose to have its entire bond portfolio invested in Commonwealth government bonds, since this is the "risk-free" asset for the Fund.

In the absence of a Commonwealth government bond market, alternatives for the “risk-free” asset would be Australian dollar denominated bonds issued by AAA – rated supranationals and other AAA – rated Australian State issuers. These would be inferior substitutes, lacking the liquidity that the Commonwealth government bond market can provide.

The role of Commonwealth Government Securities as long term investments

The demand for fixed interest assets, including Commonwealth government bonds, as long term investments will rise over time as full funding of NSW public sector superannuation liabilities is approached. This is because a conservative investment strategy, based largely on low-risk fixed interest assets, will suffice once liabilities are close to fully funded.

Once defined benefits have ceased accruing and are close to fully funded, minimising the risk of a superannuation deficiency re-appearing is likely to be more important to government than maximising investment return.

This should also be the case with other closed defined benefit superannuation funds, government and corporate, as they approach full funding or as pension liabilities come to predominate. There has been a recent example in the United Kingdom of a corporate pension fund deciding to invest 100% of its assets in bonds.

The NSW public sector superannuation fund is 2/3 funded and pension liabilities are nearly 1/2 the fund’s liabilities. While full funding will not be achieved until 2030, the proportion of liabilities attributable to pensions for retired employees will grow fairly rapidly, as remaining members of the closed schemes retire.

Corporate bonds have credit risk and usually have shorter tenor than government bonds, making them inferior substitutes for government bonds as long term investments.

Funding superannuation liabilities

NSW public sector superannuation liabilities are large but effectively capped in real terms, since (with financially minor exceptions for Judges and Members of Parliament) the defined benefit schemes for public sector employees have been closed to new members.

The NSW government originally adopted a target of fully funding these superannuation liabilities over 50 years to 2045. More recently, the Government adopted a target of fully funding these liabilities over 35 years to 2030.

Above average investment returns during the 1990s on the financial assets held in the public sector superannuation fund were a significant factor in making this earlier target feasible.

The funding plan of Government contributions (constant in real terms to 2030) derived from the 2030 target implies that the superannuation fund will continue to hold financial assets of around $30 billion to $35 billion for the next 30 years. In due course, all these financial assets will be liquidated to pay fortnightly superannuation pensions.

NSW Treasury acknowledges that there are financial risks involved in holding such financial assets, particularly the volatility of investment returns and the occurrence of negative investment returns from time to time.

However, there are other financial risks involved in not holding such financial assets, particularly the budget impact of the growth (in real terms) of superannuation benefits payable for the next 10 years and the volatility of benefits payable from year to year over a much longer period.

Assuming a positive equity risk premium (that is, assuming investment in equities should in the long run provide a higher return than investing in government bonds), it would cost taxpayers more if the superannuation fund did not hold financial assets and if Government instead paid superannuation benefits only as they fell due. If financial assets were not held, the cost of the equity risk premium foregone would fall on taxpayers.

Maintaining a strong balance sheet allows volatility in investment returns to be absorbed without disruption to the delivery of government services.

Governance issues for Commonwealth government superannuation funds

In NSW, the corporate trustee for the government defined benefit superannuation fund is established by statute. Employers and employees are represented by equal numbers of trustee directors and a 2/3 majority is needed for decision making. Employer representation on superannuation trustee boards need not involve senior public service managers.

Because it is a superannuation fund, the assets can be used only to pay superannuation benefits and operating expenses (advisors – actuarial, legal, accounting, asset consulting; and fees to contracted investment managers and the scheme administrator).

The trustee operates the superannuation fund independently from government. These constraints arise from trust law as well as from the statutory framework.

For government defined benefit superannuation funds, it is appropriate for government to establish the framework to ensure the investment strategy and processes are prudent. In addition, it is appropriate for government to influence investment strategy at the level of defining the amount of financial risk that is tolerable by government.

This framework could include appointing a corporate trustee, requiring the trustee to ensure that the investment strategy met the same general requirements as apply to trustees of superannuation funds, and specifying a limit to the expected volatility of portfolio investment returns.

Commonwealth entities have experience in investing (more than $30 billion) in defined benefit superannuation funds:

- Unisuper: $10 billion of assets (includes accumulation scheme assets);
- Telstra:$8 billion of assets;
- Commonwealth Superannuation Scheme: $6 billion of employee assets;
- Public Sector superannuation scheme: $4 billion of employee assets;
- Australia Post: $3 billion in assets;
- Military Benefits Scheme: $1 billion in assets;
- Reserve Bank: $600 million in assets.

The Commonwealth Bank and QANTAS also had superannuation fund investments while owned by the Commonwealth.

In NSW, the level of financial assets held in the superannuation fund has grown over time. Growing superannuation fund assets too rapidly can risk pricing impacts on domestic equity and (possibly) bond markets. Hence any accumulation of financial assets to fund accrued superannuation liabilities should occur only gradually.

Many jurisdictions, including NSW, have established appropriate corporate governance arrangements by which a corporate trustee oversees the accumulation of financial assets in a superannuation fund.

Budget impacts of government superannuation funds

NSW fiscal strategy focuses on balance sheet management, with the budget result being a means to a balance sheet end. Hence the budget result emphasised by NSW is the net lending result (called “fiscal balance” result by the Commonwealth) rather than the cash or accrual accounting result.

The net lending budget result is, broadly, the accrual operating result (revenues less expenses), plus depreciation, less capital expenditure and less revaluations.

Superannuation expense is defined by the Australian Bureau of Statistics, using Government Finance Statistics conventions, in a particular way for the purposes of calculating the net lending budget operating result. Broadly, valuation changes to superannuation assets are reflected in the budget through balance sheet movements but mostly not in the net lending budget result, because investment income received by the superannuation fund is outside the scope of budget revenue items.

The net lending budget result is affected to the extent that superannuation expense includes a notional interest charge on the average balance of unfunded superannuation liabilities. An increase (decrease) in the average balance of unfunded superannuation liabilities leads to a decrease (increase) in the net lending budget result via the notional interest charge.

However, this effect is muted as the notional interest charge is 5.8% of the unfunded superannuation liabilities.

The budget balance sheet impact does not depend on the classification of the agency (superannuation fund trustee or otherwise) holding the superannuation liabilities and assets, because it is the general government sector that owes the difference – the unfunded (or net) superannuation liabilities.

There is a direct inverse relationship between movements in the value of superannuation fund assets and movements in the general government sector's unfunded superannuation liabilities, although other factors also influence the level of unfunded superannuation liabilities.

With non-superannuation investments (such as the Treasury Managed Insurance Fund), investment income, including financial asset valuation changes, is a budget revenue item. The investment revenue from the financial assets backing incurred insurance liabilities is less than 1% of total budget revenue.

Compared to not holding financial assets, volatility in investment return introduces a degree of uncertainty for NSW government fiscal policy, through its effects on the balance sheet and the net lending result. However, this volatility is acceptable in view of the long term benefits of holding financial assets to fund liabilities. In particular, holding financial assets insulates the delivery of government services from the impact of growing cash outlays that would otherwise be needed to meet growing benefit payments on a pay-as-you-go basis.

Moreover, investment return is only one component of the level of net financial liabilities. Changes in gross liabilities also affect the balance sheet.

There is also a natural hedge for part of the financial risk, since the value of the financial liabilities and the value of financial assets are both sensitive to changes in interest rates, but in opposite directions.

Recently the NSW Government has decided to establish the General Government Liability Management Fund, to more flexibly manage financial liabilities. The legislative framework provides that the Fund's financial assets can be used only for superannuation contributions or to retire debt once accrued superannuation liabilities are fully funded. Accumulated assets are not expected to grow beyond around $5 billion.

Australia as a global financial centre

Australia's competitive strengths as a global financial centre include its skill base and the quality of the supporting infrastructure and the broad range of ancillary services. These sorts of advantages are underpinned by the breadth and scale of domestic financial markets, which in turn have been enhanced by a floating Australian dollar, tariff reductions and compulsory superannuation contributions.

The Commonwealth government bond market is a wholesale market with large individual transactions and remains important to the breadth and scale of domestic financial markets generally and the interest rate futures market in particular.

Winding down the Commonwealth bond market would be likely to have an adverse impact on Australia as a global financial centre.

Conclusions

The role of Commonwealth Government Securities as long term investments is likely to grow in importance as superannuation pension funds become more funded and as pension liabilities dominate employee contributor accruals in these funds.

The Commonwealth Government Securities market should not be further reduced in size. Nor is there any compelling reason to grow the CGS market at any predetermined nominal rate. If the Commonwealth decides instead to further reduce the size of the CGS market, any such reduction should be gradual and financial markets informed about the rate of reduction.

The preferred option is for the Commonwealth to gradually begin to fund its accrued superannuation liabilities.